Flawed logic

Regulators' confidence in extra ratings 'misplaced'

The regulatory drive to require multiple ratings for European structured finance products may not achieve its intended aims, despite necessarily adding costs. The findings of a recent Finance Research Letters study suggest that the regulatory initiative is based on an understanding of market practices that is not borne out by facts.

Conventional wisdom states that investors gain comfort from additional ratings and that therefore extra ratings on a security would go hand-in-hand with lower coupon payments. This forms part of the understanding of rating shopping; that only attaining a single triple-A rating, for example, shows that a deal was structured to meet the minimum possible requirements for a triple-A rating and therefore a deal with additional triple-A ratings has met higher standards.

However, based on the conclusions of a study undertaken alongside Frank Fabozzi and Dennis Vink, Bishopsfield Capital Partners partner and co-founder Mike Nawas has come to the opposite conclusion. "The evidence shows that investors actually demand greater compensation for additional ratings," he says.

The study examined triple-A rated euro-denominated senior RMBS issued from 1999 to 2006. This covers the period leading up to the financial crisis and the bulk of the European RMBS market from that time.

The sample used included 421 tranches, representing 79% of the entire set of euro-denominated triple-A rated senior RMBS issued during 1999-2006, with a total par value of €221.15bn. The study only considered floating-rate tranches benchmarked off Euribor and issued at par, as par pricing helps to judge a tranche's relevant incremental funding cost at issuance.

The study shows that senior tranches with three triple-A ratings were issued at an average of 5bp wider than senior tranches with only one triple-A rating, and an average of 2bp wider than tranches with two triple-A ratings. These additional ratings appear to be necessary in order to deal with added structural complexity.

What the pattern suggests is that additional ratings, as EU regulators are requiring, do not in and of themselves make investors more comfortable. Perhaps this means a change in approach to ratings is more important than simply requiring more of them.

"Forcing issuers to attain multiple ratings will, in itself, not make the market any safer. What the EU would really like is to create space for more rating agencies, because the big three are very dominant, but that change has not materialised and the big three have retained their position and importance," says Nawas.

He continues: "In a market where everything is highly rated, what you really need is more detail. It is important that investors understand the complexity of credit valuation and policymakers should be more concerned about whether investors understand how complex the investments they are taking actually are."

Nawas believes, for example, that it is a mistake for investors to neglect to run scenario analyses. He would welcome an increase in scrutiny and maybe even a more detailed approach from rating agencies, rather than an analysis that hardly distinguishes between complex and non-complex structured finance securities, which is currently common.

"In a market where everything is highly rated, you need more detail," says Nawas.

Additionally, encouraging greater reliance on ratings – by imbuing them with additional significance through regulating for a greater role for them – appears contradictory with the other great regulatory belief that rating agency failings contributed to the financial crisis. Regardless of the mixed messages from regulators, the study shows that the message which investors have received from additional ratings is that they have been necessary for complexity reasons.

The study hypothesised that issuers needed to attain more than one triple-A rating for securities that investors consider to be more complex than typical. This proved to be true for both tranches with more credit enhancement than average and for senior tranches that were split into super-senior and senior-subordinated.

Issuers typically minimise subordination to the lowest level that will still achieve a triple-A rating, as this minimises a transaction's total funding cost. If a senior tranche has a relatively high level of subordination, investors will assume that this is the minimum amount of subordination that was required for a triple-A rating – thus raising their concerns in comparison with other deals where a triple-A rating was achieved with less subordination. Investors then require greater compensation because they have had to do more work to assess the investment.

There is also added complexity in the case of splitting the senior tranche into super-senior and senior-subordinated. Again, if this means more investor scrutiny is required, investors will expect to be paid more than they otherwise would.

The study found a highly significant correlation for greater subordination and additional triple-A ratings. This was also the case for senior-subordinated tranches and multiple triple-A ratings.

"Our results have an important implication for EU regulatory reform. The EU refers to RMBS as 'complex' securities. However, triple-A RMBS tranches can vary in complexity," states the study.

It continues: "Policymakers should be cognisant of the risk that a requirement of a minimum of two ratings for all structured finance securities could not be meaningful for senior tranches (without complex features), while it increases the cost to issuers, who could otherwise have chosen only one CRA to rate a tranche. Our findings suggest that the EU's regulations governing the minimum number of credit ratings on complex senior securities should be reconsidered until there is a better understanding of the signal provided by multiple ratings."

Nawas adds that further research into how credit ratings affect structured finance transactions is needed. This should come before any more punitive regulatory initiatives are put in place.

He concludes: "Rating shopping, in the classical sense, appears to be more applicable to the corporate bond market. However, what is really important is that regulators must keep in mind how different structured finance is to corporate bonds and understand that this is a unique market, with its own specific characteristics."

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